U.S. Department of Agriculture
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U.S. DAIRY POLICY: PARITY, COST OF PRODUCTION OR DIRECT PAYMENTS?

Thank you. I appreciate being here this morning to talk with you about U.S. dairy policies. Although I don't administer any dairy programs, I do have the responsibility for the budget and to insure that the Secretary has a sound analytic basis for the policy decisions he must make. Because we've had several important dairy policy decisions to make over the past two or three years, I have been involved frequently in dairy issues.

As your program indicates, I want to talk mainly about how we base dairy price supports and about parity and its primary alternative--the "cost of production" concept. One or another variant of these economic concepts continues to be the primary choice for determining a standard for price and income support programs. And I want to comment on the current situation our dairy program faces. But I also want to listen to you and others who may wish to comment so I will try to be brief and give some thoughts for your consideration; I hope we'll be able to expand upon those thoughts throughout the balance of the session.

As I look around the room today, I see a number of persons who participated in our New Orleans discussion on similar topics last November. Some of what I will say today will be very familiar to you, and I want to apologize for covering some of the same ground today.

At the outset, I want to say that I believe our dairy program is one that works, and has worked well. There have been times when supports were inadequate and farmers went through a squeeze; and there also have been times when milk production was too high and surpluses were large and relatively costly. But, by and large, the program does what it is supposed to do: it prevents wide

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Remarks by Howard W. Hjort, Director of Economics, Policy Analysis and Budget, before the Northeast Dairy Conference, Burlington, Vermont, April 2, 1980.

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fluctuations in milk prices by putting a floor on the down side, and it moderates upswings by moving stocks into the market.

Program performance can also be measured by comparing dairy product prices with food and non-food prices. In February 1980, the dairy produce price index at grocery stores averaged 219.5 while the price index for all food at home was 241.3, with 1967 equal to 100. The Consumer Price Index for all items was 236.4. That is, even though returns to dairy producers were relatively favorable in February, dairy product prices were 9 percent lower than all food prices and 7 percent below the average for all items.

This is the consequence of the large increases in productivity we have seen since 1967 and, more generally, over the last 30 years. Total milk production has varied relatively little since 1949--milk production this last year was only about 6 percent above the 1949 level and only 3 percent below the peak production year of 1964. Yet, the amounts and types of resources used in dairy production have changed dramatically. The milk we consumed in 1978 was produced with only one-sixth the amount of labor used in dairy production in 1949. Labor productivity gains since 1949 have been greater in milk production than for any other agricultural enterprise, except for cotton.

These gains have come about in three ways. Each cow produced more milk--more than twice as much on the average in 1979 as in 1949. Second, the average producer milks more cows--the typical dairy herd size more than quadrupled between 1949 and 1979. And, today's average producer uses more and better machinery in milk production than in the past.

Each of those changes has meant more capital investment. Dairy producers have been willing to invest that capital, and lending institutions have been willing to underwrite those investments because the economic outlook for dairy products has been relatively stable even when the industry was in a major

transition. To me, that relatively smooth transition, accommodating as it did vast changes in the economic structure of this industry, is proof that the dairy program is serving the Nation well.

Another way of looking at the dairy program is to say that it works because it serves both producers and consumers. I submit that it will continue to work as long as it continues to serve both groups. Should it fail to serve either group well, it will fail from lack of support.

I mention that double responsibility because it means that the Secretary can never manage such a program to the complete satisfaction of either group--that it is becoming increasingly difficult to balance these interests. Some consumers tend to want lower prices than will give producers the essential incentives for adequate supplies of milk in the long run. Some producers tend to want higher supports than are justified to provide an adequate supply. Secretaries of Agriculture must work to strike a balance--a task as difficult to do as it is unpopular to attempt on some occasions.

We've had our share of such occasions. I know that some of you have serious concerns about recent policy decisions and with some developing issues. One such issue is the Administration's recent proposal to amend the dairy bill. The upcoming decision on hearings on reconstituted milk under marketing orders is a second. Questions concerning the Capper Volstead Act and undue price enhancement are a third. The dairy provisions in the new import quota rules under the recently-completed MTN agreement are a fourth. Utilization of casein imports is a fifth.

With regard to the casein import issue, let me comment that although the Secretary does not feel that he has enough evidence to request a Section 22 action, he is planning a further examination of the issue in an effort to

determine more specifically the incidence and extent of impacts on domestic producers and consumers. Extensive information on the economics of casein production and its use will be needed. We will be specifying our information needs and begin discussions of cooperative work during the next few weeks.

There are also other questions, but there is not time to discuss all of these issues and still talk about parity in detail. We may get into those in a later discussion.

I am one among many who believes that events have more to do with policy than policy has to do with events. Perhaps it's difficult to confirm that hypothesis with examples from the dairy industry whose program has worked well; yet, in the larger scheme of policy formulation, it seems quite evident. As we consider dairy policy, there are several general events as well as some specific ones, that should be kept in mind.

First, the more open decision-making system that is being followed today has changed the scope and nature of policy determination. Unless you have examined the process carefully, it is very difficult to appreciate the change in the degree of public participation in the decision-making process for farm programs now compared to when I left government in 1969. That is, I believe, an irreversible trend.

Second, considerably more resources are devoted to decisions now and the process has become more complex as other agencies within the Executive Branch play an increasing role in policy decisions affecting food and agriculture. When one compares the size of the staffs that serve the various committees of the Congress, it again becomes evident. It is even more evident when one compares the size of the groups representing various industries in Washington in the political process. This also, I believe, is an irreversible trend.

Don Paarlberg, my predecessor, and I have compared notes on this over time. In 25 of the last 27 years or so, either Don or I have been in Washington, and we have frequently compared notes about the complexity of the decision-making process. When Don came back in 1969, he said, "Howard, I am appalled," after reviewing the papers that had been used in a decision.

When I came back in 1977, it was my turn to say, "Don, I am appalled!" And, the process is more complex now than it was in 1977.

Consumer involvement in farm program decisions definitely is greater now than in the late 1960's. The organized groups are larger and there are more of them. They are better organized and have more staff resources to participate in the decision-making process. They have become more mature and will continue to be involved.

Basic economic conditions are a greater factor in today's events and policies. After becoming accustomed to very stable prices for feedstuffs--grain and meal--during the 1950's and 1960's, the dairy industry was unprepared for the serious economic shocks when these prices became volatile in the 1970's. You recall the experience in the early 1970's when your feed prices escalated rapidly--much more rapidly than the parity index. In consequence, milk price supports fell below your cost of production.

I expect that we will continue to face volatile prices for feedstuffs during the 1980's. Comparing the outlook for oilseeds, feed grains, and food grains on a world scale, consumption of oilseed meals will grow the most rapidly and the consumption of feed grains will be second. Food grain consumption growth will be third. The odds clearly indicate rising prices of feedstuffs relative to prices in the general economy for the whole world.

Price inflation also has its impact. Price inflation continues to be an increasingly difficult problem for everyone in the world. Globally, the rate of

price inflation in the 1970's was three to five times higher than in the 1960's. Mainly because of inflation, support prices for dairy products have increased 39 percent in the last three years. In those circumstances, the decision process becomes increasingly complex even from another standpoint: an almost frantic effort to review all programs, all activities, and all decisions, to see which ones can have an impact on inflation.

Relatively slow economic growth is another consideration. Our country and the rest of the world has moved into a slow, phased-down period of economic growth. In the near-term, that means the growth in demand for dairy products will be slower than it has been in the last half of the 1970's.

Finally, there is the overwhelming desire on the part of the American people to balance the Federal budget. The President sent his plans to balance the FY 1981 budget to the Congress the day before yesterday. In such an environment, it is increasingly difficult to find support for the funds needed to operate dairy programs.

I mention this now for a specific reason. Yesterday, one day after the President sent his new and substantially reduced FY 1981 budget to the Congress, the Secretary announced (as the law required him to do) a substantial increase in milk price supports--about 7.6 percent. Yesterday's increase together with the 6.8 percent increase made last October, adds up to a 14.4 percent increase this year. According to our most recent data, the price of milk in 1979 significantly exceeded most producers' cost of producing milk.

Recently, supports have been increasing faster than the per unit cost of milk production. While many things farmers must buy to produce milk have increased in price, stable feed prices and sharply increased productivity are holding down the cost per hundred pounds of milk produced. During 1980 we expect that it will cost the average producer between \$11.24 and \$11.50 to

produce each hundredweight of milk, up only about 8 percent over 1979. Feed costs which make up about 44 percent of those costs are expected to increase only about 2 percent.

The support price at the beginning of the 1979/80 year was $11.49 cents. It was boosted to $12.36 on April 1--yesterday--and it is scheduled to rise to somewhere between $13.00 and $13.25 on October 1. By most economic measures, dairy farmers are making money and have very strong economic incentives to produce milk. In response to these incentives, production is increasing rapidly--much more rapidly than commercial use. We expect the 1979/80 commercial milk supply to be up about 4.6 billion pounds (3.6 percent) over last year. Commercial use is projected to increase 1.1 billion pounds. As a result, we expect CCC net removals to increase 3.9 billion pounds to 5.0 billion pounds. The cost of the program will go to about $.8 billion--3-1/2 times last year's level. And based upon the track record of our experts so far this year, I conclude that the odds on a larger instead of a lower cost are higher.

We have been working closely with producer groups in recent weeks to find out if they share our view of the situation and outlook. They generally agree with our numbers and they tend to share our concern. To be blunt, the program is in trouble. It is providing producers with strong economic signals to increase production at a time when milk and milk products are in surplus supply. It is inflexibly increasing support levels and consumers' costs at a time when retail prices are already high and food price inflation a matter of serious national concern. And, it is providing producers increases in returns not fully justified by costs.

The danger of such a situation is only partly reflected by the increase in program costs. Once consumers lose confidence in a program, it is extremely difficult to restore. Sugar is an example. In 1974, the Congress declined to

renew the sugar program. Prices fell sharply in 1977 and this Administration proposed a new program in 1978 that was passed, but not enacted when the conference report was not accepted in the last moments of the session. Last year, a sugar bill failed again even though it had a specific cap that limited support increases to 7 percent. By the time the House finally voted, many producers felt the bill had more consumer than producer protections--but many traditional consumer-oriented spokesmen opposed it vigorously and it failed badly.

The dairy amendment the Administration proposed last year was designed to prevent just such a backlash. It would not have reduced supports--ever. It would have given the Secretary authority to not increase supports when surpluses are building rapidly--as they are today.

It is unfortunate for the industry that such a provision was not included in the law so that we could have moderated the April 1 increase this year. The danger signals were strong earlier. Now at least some serious problems are inevitable. We are almost certainly going to have very large purchases, excessive stocks, and very high levels of outlays well into the future. At least part of this problem could have been avoided.

The Administration stands ready to work with the industry to design and implement the changes we need to align the economic signals the program gives producers with economic reality. Any such changes will require a joint effort between the industry, the Administration and the Congress if they are to be well received.

We do not have any proposal to change dairy legislation before the Congress at this time. We will request authority from the Congress to remove the semi-annual adjustment requirement from a number of programs. We considered

including the dairy programs in that package, but we did not. There simply was not time to design and work out such changes before the April 1, 1980 increase was due. But that does not mean we are not concerned about the future of this program--about the danger of its losing its public support because of the very high costs it is now incurring.

Two kinds of changes could be considered, I believe. The first would give the Secretary authority to modify scheduled changes in supports under certain specific circumstances--authority to send a small but clear, economic signal to producers that production is growing either too much or too little.

It would be relatively simple to change the Secretary's authority so that whenever supplies and government purchases are expected to be excessive and the cost of producing milk is increasing less rapidly than the parity index, scheduled increases in the price support for milk would be modified. Part, or all, of an increase would be foregone.

In the opposite situation, it would be appropriate to raise supports more than the scheduled increase. When we expect tight supplies and when the cost of producing milk is rising more rapdily than the parity index, scheduled increases could be increased so producers would have the economic incentive to produce an adequate amount of milk.

To work well, such a mechanism must send the correct economic signal, and the signal must be clear and early. A system that tells producers to overproduce and then puts them through an economic wringer--and in the process tells them to underproduce, thereby starting the whole process over again--serves neither producers nor consumers.

I would be the first to admit that economic projections are imperfect at best. But I also believe small economic adjustments based on projections are a lot more effective than trying to deal with surpluses or shortages after they develop.

The second class of changes would be more fundamental. Here we have several alternatives. First, we could stay with the parity standard, but give the Secretary authority to support prices at a lower percentage of parity when that is appropriate,and/or modify the semi-annual adjustment formula so today's problem could be avoided. Second, we could explicity shift to much greater reliance on an index based on the cost of producing milk. Third, a program similar to those for grains could be considered. The market price for milk could be supported at a level that permits the quantity produced to move into the market without governmental intervention. Where prices and returns were below national average production costs, a payment would be made directly to producers.

A direct payments program for milk producers would need to be based on producers' full cost of production. Under this approach prices would be set entirely by the market. And, a higher share of stocks would be held by handlers and cooperatives, rather than by the government. Dairy product prices to consumers would be lower and, therefore, consumption of dairy products a little larger. Costs to taxpayers would be slightly lower compared to current programs for any given level of producer income because the payments would go directly to producers.

Economists have generally felt that there would be a serious problem with a direct payments program for dairy producers. Both seasonal and longer-term prices would be less stable. There would still be a government established price support but it would be lower. There would be a serious risk of chronic market instability. The seasonal trends would be difficult to separate from longer-term trends. Adjustments would be more likely to cause shortages and surpluses and still wider swings in prices. Producers would have less incentive to reduce production during surplus periods because their incomes would be protected.

But the key to any program is the standard for price or income support. The policy standards are parity, and cost of production. Today only two agricultural products are governed by the parity standard, milk and tobacco. There are many references in other statutes to parity, parity prices and parity returns, but the standard that is used to change the key income support levels for the grains, cotton and oilseeds is not a parity standard. It is cost of production. Adoption of this standard has taken time. However, there is an increasing gap between the cost of production standard that is used generally and the parity standard still used in the dairy programs.

Let's look specifically to the question of how well parity meets the objectives of the dairy programs. First of all, what is parity? We need to keep in mind that parity measures changes in prices--not changes in costs or incomes. When one refers to 80 percent of parity, we're making a comparison strictly between prices at a particular time with a previous time.

The parity concept does not say anything about costs or net returns. And, because the weights in the parity index do not measure expenses for today's dairy producers, parity will rarely indicate just the price support changes needed. Compared to actual expenditures in 1979, the parity index had only about one-fourth the appropriate weight for changes in feed prices and only about one fifth the appropriate weight for all labor costs and wage rates.

When dairy producers talk to me about their concerns I usually hear about feed costs, wages, fuel costs, replacement stock prices and interest rates. The parity index greatly under-weights the two most important of those five items--especially, feed costs.

I have already referred to the fact that the key reason dairy farmers lost money in the mid-70's was the extreme increase in feed costs. Support increases lagged far behind. To some extent the use of the parity index as a basis for dairy price supports actually makes it harder to manage the dairy program well. Whenever costs change more than the index, an extraordinary adjustment of some kind is required. At best, such adjustments can come in for a great deal of attention--sometimes unwelcome attention. At worst, the needed change might be beyond the Secretary's authority.

Not only does a parity index sometimes give the wrong economic signal, but it is slow in correcting wrong signals. A cost of production index, because it measures dairy producers' costs directly, provides a much earlier warning of changing economic circumstances and a good cost of production estimate would be a much more reliable as an indicator of corrections that must be made.

The parity index does not take into account productivity. A cost of production index does. The more parity-based supports increase relative to producer costs, the more pressure we face from consumers to adjust the support price lower and lower on the parity scale so that consumers can share in productivity gains. The problem with such adjustments is that they tend to be made blindly--without specific economic evidence as to the most appropriate support level.

Let me illustrate this point. Feeder calf prices are weighted in the parity index of about 12 percent. When we have a situation like we had this past year when feeder calf prices increased sharply, the parity index increases more sharply than farmer costs for two reasons. Dairy farmers do not ordinarily buy feeder calves, and so they do not pay any more as a result of the increase in feeder calf prices. Additionally, many farmers sell cull calves as feeder calves. As a result, the increase overstates a cost increase and does not reflect an income increase.

When we make upward adjustments in such circumstances, we are increasingly vulnerable to criticism. Adjustments take on a political nature. That's all right as long as the program is still perceived to be working well, but if we find supplies are in excess of requirements, we're under increasing pressure to lower levels of support.

I know that feelings run high in the dairy industry about the use of the parity index. It has been the standard for a good many years. I'm aware of the argument that dairy prices at about 80 percent of parity would have moved generally in the same direction as producer costs over the past two decades--that prices at about those levels would have been relatively stable but still would have brought forth adequate milk supplies. However, supports based on parity were too high in the early 1960's and surplus stocks built up sharply. The program came under serious attack. In this decade, supports have been both too low and too high.

Some of the support for the parity index is based on the belief that somehow having support prices tied to parity means that they are both higher than they would be if they were based on any other concept and that the parity concept is easier to defend. Neither of these concepts is completely correct.

Price supports at a given parity ratio will sometimes be above the cost of production and sometimes below. As I read the basic economic signals, the odds are that they're more likely to be below rather than above in the future. Support prices that are too low cause producers economic hardship in the short run, and may lead to tight supplies and higher prices in the longer run. Such prices mean less stability within the industry.

Support prices that are too high overstimulate production; if they persist, they lead to reduced supports. Producers and consumers are both better off if

supports generally track producers' costs of production and if the market signals for production adjustments can be clearly understood.

I want to make an additional comment at this point. During the recent budget review, the government began to look closely at indexing in general. That process will intensify in the future. There are too many indexes that lead to important changes for the wrong reason--and, almost certainly they lead to the wrong changes.

There will be some that agrue that all indexing should be stopped--that inflation is made much worse by the fact too much of the economy has too small a stake in stable prices. I would not expect that indexing will disappear, but I do think that there will be very serious efforts to make it more logical.

I mentioned earlier some elements of the parity index that are not logical as a basis for dairy price supports. There are such cases in many indexes. For example, Social Security payments are adjusted on the basis of changes in the Consumer Price Index. However, the CPI is based on purchases of the average U.S. consumer, not the elderly. As a result, when housing costs increase sharply, Social Security levels are increased rapidly because shelter costs are weighted at 31 percent in the CPI. The elderly tend to spend less than the average American on housing, so many are overcompensated. The same thing happens when the CPI increases as a result of food price increases.

However, the elderly spend more than the 4.7 percent average on fuel costs and more than the 4.8 percent average on medical costs, to give two examples. When fuel and medical costs increase more than other costs, Social Security recipients tend to be undercompensated. Some argue that the housing and medical disparities balance out food and housing disparities for social security recipients. That is a dangerous approach which can result in disaster if all

the disparities move against the Social Security recipient. The appreciation of these potential dangers is growing. I expect very serious efforts to develop consistent and logical indexes across the economy.

I have no illusion that policy changes for the dairy industry would be either easy to design or inexpensive to maintain. I do believe that any new standard will be more likely to work well if it is designed in close cooperation between the industry and the government. If the industry has a strong role in both the development and the testing of a new standard, it is likely to have fewer problems and certainly more likely to have industry support than if the government alone does the designing. But we can all be certain that the cost of producing dairy products will be a factor of even greater importance in dairy price support policy in the future. I would certainly welcome any comments you have.

Thank you.

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